

shall be made with respect to the taxable income of the partnership but the limitations on tax under section 481(b) shall apply to the individual partners. Each partner shall take into account his distributive share of the partnership items, as so adjusted, for the taxable year of the change. Section 481(b) applies to a partner whose taxable income is so increased by more than \$3,000 as a result of such adjustments to the partnership taxable income. It is not necessary for the partner to have been a member of the partnership for the two taxable years immediately preceding the taxable year of the change of the partnership's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a partner may apply section 481(b)(2) even though he was not a member of the partnership for all the taxable years affected by the computation thereunder.

(ii) In the case of a change in method of accounting by an electing small business corporation under subchapter S, chapter 1 of the Code, the adjustments required by section 481 shall be made with respect to the taxable income of such electing corporation in the year of the change, but the limitations on tax under section 481(b) shall apply to the individual shareholders. Section 481(b) applies to a shareholder of an electing small business corporation whose taxable income is so increased by more than \$3,000 as a result of such adjustments to such corporation's taxable income. It is not necessary for the shareholder to have been a member of the electing small business corporation, or for such corporation to have been an electing small business corporation, for the two taxable years immediately preceding the taxable year of the change of the corporation's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a shareholder may apply section 481(b)(2), even though he was not a shareholder, or the corporation was not an electing small business corporation, for all the taxable years affected by the computation thereunder.

(6) For the purpose of the successive computations of the limitations on tax under section 481(b) (1) or (2), if the

treatment of any item under the provisions of the Internal Revenue Code of 1986 (or corresponding provisions of prior internal revenue laws) depends upon the amount of gross income, adjusted gross income, or taxable income (for example, medical expenses, charitable contributions, or credits against the tax), such item shall be determined for the purpose of each such computation by taking into account the proper portion of the amount of any adjustments required to be taken into account under section 481 in each such computation.

(7) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning section 1314(a) for such year.

(8) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to tax on self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) *Examples.* The application of section 481(b) (1) and (2) may be illustrated by the following examples. Although the examples in this paragraph are based upon adjustments required in the case of a change in the over-all method of accounting, the principles illustrated would be equally applicable to adjustments required in the case of a change in method of accounting for a particular material item, provided the treatment of such adjustments is not specifically subject to some other provision of the Internal Revenue Code of 1986.

*Example (1).* An unmarried individual taxpayer using the cash receipts and disbursements method of accounting for the calendar year is required by the Commissioner to change to an accrual method effective with the year 1958. As of January 1, 1958, he had an opening inventory of \$11,000. On December 31, 1958, he had a closing inventory of \$12,500. Merchandise purchases during the year amounted to \$22,500, and net sales were \$32,000. Total deductible business expenses were \$5,000. There were no receivables or payables at January 1, 1958. The computation of taxable income for 1958, assuming no

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other adjustments, using the new method of accounting follows:

Net sales .....	\$32,000
Opening inventory .....	\$11,000
Purchases .....	22,500
Total .....	33,500
Less closing inventory .....	12,500
Cost of goods sold .....	21,000
Gross profit .....	11,000
Business expenses .....	5,000
Business income .....	6,000
Personal exemption and itemized deductions .....	1,600
Taxable income .....	4,400

Under the cash receipts and disbursements method of accounting, only \$9,000 of the \$11,000 opening inventory had been included in the cost of goods sold and claimed as a deduction for the taxable years 1954 through 1957; the remaining \$2,000 had been so accounted for in pre-1954 years. In order to prevent the same item from reducing taxable income twice, an adjustment of \$9,000 must be made to the taxable income of 1958 under the provisions of section 481(a) and § 1.481-1. Since the change in method of accounting was not initiated by the taxpayer, the \$2,000 of opening inventory which had been included in cost of goods sold in pre-1954 years is not taken into account. Taxable income for 1958 is accordingly increased by \$9,000 under section 481(a) to \$13,400. Assuming that the tax on \$13,400 is \$4,002 and that the tax on \$4,400 (income without the adjustment) is \$944, the increase in tax attributable to the adjustment, if taken into account for the taxable year of the change, would be the difference between the two, or \$3,058. Since the adjustment required by section 481(a) and § 1.481-1 (\$9,000) increases taxable income by more than \$3,000, the increase in tax for the taxable year 1958 attributable to the adjustment of \$9,000 (i.e., \$3,058) may be limited under the provisions of section 481(b) (1) or (2). See examples (2) and (3).

*Example (2).* Assume that the taxpayer in example (1) used the cash receipts and disbursements method of accounting in computing taxable income for the years 1956 and 1957 and that the taxable income for these years determined under such method was \$4,000 and \$6,000, respectively. The section 481(b)(1) limitation on tax with a pro rata three-year allocation of the \$9,000 adjustment is computed as follows:

Taxable year	Taxable income before adjustment	Taxable income with adjustment	Assume total tax	Assumed tax before adjustment	Increase in tax attributable to adjustment
1956 .....	\$4,000	\$7,000	\$1,660	\$840	\$820
1957 .....	6,000	9,000	2,300	1,360	940
1958 .....	4,400	7,400	1,780	944	836
Total .....					2,596

Since this increase in tax of \$2,596 is less than the increase in tax attributable to the inclusion of the entire adjustment in the income for the taxable year of the change (\$3,058), the limitation provided by section 481(b)(1) applies, and the total tax for 1958, the taxable year of the change, if section 481(b)(2) does not apply, is determined as follows:

Tax without any portion of adjustment .....	\$944
Increase in tax attributable to adjustment computed under section 481(b)(1) .....	2,596

Total tax for taxable year of the change ..... 3,540

*Example (3).* (i) Assume the same facts as in example (1) and, in addition, assume that the taxpayer used the cash receipts and disbursements method of accounting in computing taxable income for the years 1953 through 1957; that he established his taxable income under the new method for the taxable years 1953, 1954, and 1957, but did not have sufficient records to establish his taxable income under such method for the taxable years 1955 and 1956. The original taxable income and